PUBLIC CITIZEN

215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

September 14, 2015

Commissioners
U.S. Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549–1090.

Listing Standards for Recovery of Erroneously Awarded Compensation
RIN 3235–AK99
File Number S7–12–15

Dear Commissioners,

On behalf of more than 400,000 members and supporters of Public Citizen, we offer the following comments regarding the Security and Exchange Commission's proposed rule to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act covering "Listing Standards for Recovery of Erroneously Awarded Compensation."

The premise of this statutory provision involves no controversy. Incentive compensation based on results that are later proven false should be returned. Congress explained in the Senate Report that the Dodd-Frank provision was meant to prompt companies "to recover money that they erroneously paid in incentive compensation to executives as a result of material noncompliance with accounting rules. This is money that the executive would not have received if the accounting was done properly.''[1]

In the end, a well implemented and enforced claw back policy should help reduce the temptation of management to fudge the numbers. Researchers Lilian H. Chan, Kevin C.W. Chen, Tai-Yuan Chen and Yangxin Yu in the Journal of Accounting and Economics have affirmed that where firms have implemented a claw back policy, the auditor is less likely to report a material weakness.[2]

[1] Senate report at p. 135
[2] *See* Chan, Chen, Chen, and Yu *The effects of firm-initiated clawback provisions on earnings quality and auditor behavior* Journal of Accounting and Economics 54 (2012) 180–196.

A robust claw back policy can also help to ensure integrity in corporate America. As such, serving shareholder interests by clawing back compensation may also serve to steer wayward corporate managers from destructive manipulation back to productive enterprise.

The 183 words that comprise Dodd-Frank Section 954 are intended to help achieve this policy by mandating that the SEC adopt rules requiring all publicly traded companies to adopt a claw back policy which:

*is triggered by an accounting restatement due to material non-compliance with financial reporting under the federal securities laws;

* covers any current or former executive officers who have received incentive compensation based on erroneous statements;

* requires the recovery of incentive compensation paid during the three-year period preceding the date on which the company is required to prepare the restatement.

* does not require misconduct (by the covered executive officers or otherwise) to trigger the claw back obligation.

* Requires that companies must disclose their claw back policies in their public filings.

We compliment the Commission for at last registering progress on this long dormant statutory mandate. While the point of the statute is simple enough, details of implementation require answers to a number of questions. We believe the Commission has proposed answers to many of these questions in a manner that will serve to enforce the intent of the statute, and therein, shareholders. However, we believe the Commission has taken a wrong turn at several other crossroads. Here are some of our major concerns. We provide more detail on these and other issue below:

- The three-year look-back should be determined as of the date of publication of the erroneous figures.
- Companies should disclose the details of all individual clawbacks, including the names, amounts and calculations for each individual annually on the S-K .
- Where some compensation is qualitatively determined, the amount of this portion that is recovered should be proportional to the amount recovered that is numerically determined.

We now address some of the key elements of the Commission’s proposal.

1. Disclosure of claw backs

The Commission proposes to require firms to disclose where they have elected *not* to require a recovery of compensation following a restatement. This includes the names of those individuals and the reason for such an election. We support this disclosure requirement.

We also strongly urge the Commission to require disclosure of each individual from whom compensation *is* recovered, along with the amounts and how this recovery amount was determined.

Specifically, the Commission should require firms to declare whether or not a claw back has been initiated and completed, along with the details of the sums recovered and the identity of the executive from whom compensation was clawed back. This can be disclosed in the 8-k. Section 954 does not rely on the SEC to enforce a claw back policy. Shareholders may bring litigation under this statute. Shareholder enforcement and public understanding will be greatly enhanced if firms must disclose the details of any claw backs including the *rationale* for the clawback. In 2012, JP Morgan Chase clawed back certain compensation from three traders involved in the so-called London Whale fraud. But the firm did not detail the amount of the claw back. [3] WalMart reportedly clawed back certain pay, but it was unclear if this was related to a Mexican bribery case or to other issues.[4] With disclosure of specific reasoning, these details would be understood by investors. Requiring disclosure which includes explanation should also provide a prophylactic against firms that restate but do not meet their 954 obligation to recover funds.

The statute requires that firms' disclose their policies, and there is no better policy disclosure than one complete with details of implementation.

2. Executives covered

We support the Commission's identification of "executive officers" as those provided under the SEC's rule 16a-1(f). This includes the president, any vice president in charge of a principal business unit, division or function, any other officer who performs a policy making function, or any other person who performs similar policy making functions. Executive officers of subsidiaries should also be included in this definition. Section 954 does not require that a firm identifies any particular executive as responsible for the misstatement. It envisions collective responsibility as a mechanism for more responsible corporate decision making. A broad definition of executive will broaden the pool that can police reporting irregularities.

We cannot support the Commission's proposed permission that firms excuse certain individuals from the claw back. The statute is clear: "The issuer will recover from any current or former executive officer" the compensation based on erroneous statements. The statute does not say that

[3] "Whale Clawbacks About Two Years of Compensation," by Dan Fitzpatrick, Wall Street Journal, (July 13, 2012), Available at: http://www.wsj.com/articles/SB10001424052702303740704577524730994899406

[4] UAW Medical Benefits Plan press release, (May 2014) Available at: http://www.prnewswire.com/news-releases/walmart-compliance-overhaul-falls-short-on-transparency-missing-key-element-of-clawback-disclosure-258159351.html

the issue may choose to recover compensation from certain officers, but may elect not to recover from other officers.

The Commission justifies this position in the proposed rule preamble with the possibility that, in some cases, the expense to claw back certain funds may be greater than the funds recovered. The statute provides no such accommodation. The purpose of the statute is not only to recover shareholder funds but also to reduce the incentive for managers to manipulate numbers. Since the prediction of legal expense for recovery is subjective, the Commission's proposed allowance can be manipulated. The proposed rule itself, however, does not even require a firm to prove that the recovery would exceed the cost of recovery. Instead, the rule simply acknowledges that a firm may elect to not recover the funds and asks them for "a brief description of the reason the registrant decided in each case not to pursue recovery." This will be a playground for artful excuse, and we can image some brief descriptions may be limited to phrases such as, "the board found it inappropriate" to recover funds.

3. Size of Company.

The Commission proposes that the rule apply to any exchange listed company. This includes smaller reporting companies. We support this inclusion since the chance for manipulation is perhaps even greater at such companies than at larger firms with a wider and arguably more vigilant shareholder base.

4. Restatement date triggering recovery

The statue provides that the recovery apply to compensation awarded "during the 3-year period preceding the date <u>on which</u> the issuer is required to prepare an accounting restatement (underline added)." The date "on which" a new statement must be prepared is clearly the date of the erroneous statement. Firms disclose financial information. That disclosure takes place on specific dates. If, on this specific date, erroneous information is disclosed, this is the date "on which" the firm must prepare a restatement.

Such a date is clear and immutable. It would make no sense to identify the three year look back as the date when the company issues the restatement. Such a date could be more than three years after the accounting fraud or misstatement. For example, in June, 2014, Hertz Global Holdings Inc. announced it would restate results for 2011. [5] In February, 2006, Bank of America announced it would restate results dating back to 2002, four years previous.[6] In April, 2014, Bank of America revealed previously undisclosed losses of $4 billion suffered during the previous four years.[7] A recent study found that the average number of days between a

---

[5] "Hertz Restates Results," Wall Street Journal (June 2014), available at: http://online.wsj.com/articles/hertz-global-to-restate-financials-1402052045

[6] See Bank of America press release, (February 2006), available at: http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=820313#fbid=h80590LeJzg

[7] "Bank of America lost billions and forgot to tell regulators," by Stephen Gandel, Fortune (April 2014), available at: http://fortune.com/2014/04/29/how-bank-of-america-lost-billions-and-forgot-to-tell-regulators/

misstatement and a restatement is 543, or nearly two years.[8] In fact, establishing a later date may motivate firms to wait three years from an accounting fraud so as protect executive pay. Further, the date cannot be the day when the preparation for the restatement commences, as such a day is difficult to determine.

Despite this, the Commission proposes that this date for the three-year look back be the date that the issuer's officers conclude, or should have concluded, that the previously issued financial statements were in error. (Where a government body orders such a restatement previously, the Commission proposes that this earlier date be used.) It posits this example to explain: "If, for example, 2014 net income was materially misstated, and a 2014–2016 long-term incentive plan had a performance measure of three-year cumulative net income, a look-back period that covered only the three years before the erroneous filing would not capture the compensation earned under that plan. While the date of the erroneous filing is easily discernible, using this date may result in listed issuers recovering only incentive-based compensation that was received during the fiscal year preceding the filing date of the financial statements that included the subsequently restated financial reporting measure." We don't understand this example and how it supports the Commission's policy choice. If the restatement takes place in 2015 and deals with income earned in 2014, then the misstated income from 2014 would be subtracted from any three-year cumulative income metric that is applied for compensation determinations in 2017. Surely no board would approve compensation in 2017 on financial results that it knew in 2017 were erroneous.

More importantly, the Commission's proposed date ignores the reality that restatements take place often as much as three years after the erroneous statement. The Commission's proposed look-back date would have the practical effect of indemnifying much ill-gotten pay.

What's worse, firms may play games with recognition of the accounting error.[9] We urge the Commission to recognize that a firm that manipulates numbers may also manipulate its way out of complying with the claw back rule.

5. Determining restatement impact on stock price-based compensation

Determining the impact of a restatement on compensation that's tied to the stock price requires care. That's because the relationship between the stock price and restated financial results may be difficult to discern. For example, if part of the CEO's bonus is based on stock price, it is difficult to know what that stock price would have been had the company's original financial statements faithfully reflected operating results. A restatement in 2015 correcting results originally reported in 2013 is likely to move the stock price on the day of that restatement in 2015. But how would the stock price have behaved if the results of 2013 were correctly

[8] From Audit Analytics, (2012), available at: http://www.auditanalytics.com/blog/restatements-where-they-come-from/

[9] The Commission recognizes that firms may play such games when it expresses this well-founded skepticism for rejecting one of the policy options. In this case, the Commission rejects the restatement publication date, because "an issuer might improperly delay filing a restatement … [to] affect the amount of compensation subject to recovery."

reported? The Commission proposes to allow issuers to determine this, suggesting the use of outside, independent consultants. We do not oppose this rubric. But we believe that public disclosure of the results of such a determination as it applies to each individual will help shareholders understand the integrity of the process. Public disclosure will ideally inhibit a board that might otherwise be inappropriately generous to the CEO.

6. Require claw back of proportional incentive compensation where it is not numerically connected to financial results.

We ask the Commission to reconsider a claw back of proportional incentive compensation where it is not numerically connected to financial results. This is a reiteration of an important suggestion in our previous letter to the agency on Section 954.

Many firms maintain bonus plans that include qualitative variables, especially for more senior executives. JP Morgan's board notes that it does not depend on "formulaic" measures exclusively, but also on judgment.[10] There may be no one-to-one correspondence between the figures in a restatement and what should be the new bonus figure. In these cases, the SEC should require that a proportionate amount of incentive compensation awarded under qualitative standards be clawed back under a restatement. For example, if a restatement would cause 10 percent of that part of the bonus based on numerical results be clawed back, then 10 percent of the bonus awarded under qualitative methods should also be clawed back.

We note that the Commission considered this proposal, but has rejected it.[11] The Commission argues that this would be inappropriate because it would reduce the amount of incentive compensation based on qualitative measures that a board may believe better reflects the interests of shareholders. We find two flaws with this reasoning. First, in practice, what the board may think about shareholder interests often isn't disclosed to shareholders, and by nature, isn't explained quantitatively. Therefore, the Commission is arguing that shareholders should simply trust that the board knows best concerning the awards of CEO pay without specific explanation. This contravenes a good governance structure based on clear disclosure. When boards do attempt to explain qualitative reasoning, it can be perplexing. For example, the JP Morgan board doubled

---

[10] Proxy Statement, JP MorganChase (2014), available at: http://www.sec.gov/Archives/edgar/data/19617/000001961714000321/jpm2014definitiveproxy.htm

[11] One commenter suggested that the Commission also require issuers to recover a proportionate amount of the compensation tied to qualitative variables or board judgment after a material accounting error. Relative to the proposed rule and rule amendments, this alternative implementation would reduce the incentive to alter the composition of an executive's compensation package to more heavily weight qualitative variables or board judgment, while increasing the incentive to more heavily weight base salary as well as performance-based compensation tied to metrics other than financial reporting measures. To the extent that performance compensation based on qualitative variables and board judgment allows the board to compensate the executive officer for performance that is otherwise difficult to measure, the reduced weight on this form of performance-based compensation could make it more difficult for the board to align the executive officer's interests with those of the shareholders. On the other hand, reduced weight on this form of performance-based compensation could make it easier for shareholders to understand the incentives of the executive officer. Because a greater amount of performance-based compensation would be at risk for recovery, implementing this alternative implementation could also increase the amount of expected compensation the executive officer would require in order to voluntarily bear the increased uncertainty.

the pay of CEO Jamie Dimon in 2014 in part *because* of the $23 billion in penalties the bank's shareholders paid for various frauds. In the board's words, "the decision to pay Mr. Dimon" the increased "incentive award of $18.5 million and total compensation of $20 million for 2013 reflects . . . the resolution of the legal and regulatory matters."[12] It is difficult to understand that acknowledgment of massive fraud and the sacrifice of shareholder funds as penalty should serve as a basis to raise the CEO's pay. Yet that word salad of an explanation is supposed to assure JP Morgan's shareholders that the pay amount and structure is justified. Second, the fact that a claw back applying proportionally to qualitative-based pay may lead to less pay of this nature is a good thing. Far too many corporate boards are captured by CEOs and pay is awarded extravagantly regardless of performance. Promoting verifiable performance metrics as opposed to qualitative judgment can help restore sanity and objective performance awards.

We thank the Commission for its consideration, and urge that the final rule be strengthened to reflect our comments. For questions, please contact Bartlett Naylor at [redacted].

Sincerely,

Lisa Gilbert, Director, Congress Watch

Bartlett Naylor, Financial Policy Advocate, Congress Watch

---

[12] JP Morgan proxy statement, (2014), available at: http://www.sec.gov/Archives/edgar/data/19617/000001961714000321/jpm2014definitiveproxy.htm#sFBBFB26CB26BA1C8C95810149F8DD3C1